

New Pension Crisis Seen In Credit Markets Crash

by Paul Gallagher

The International Trade Union Confederation (ITUC) released a report June 22 to its members in 153 countries, urging them to pull their pension funds' investments out of hedge funds and private equity funds. The ITUC, with many examples, showed that pension funds' returns from investing in these locust funds have done no better, or lagged behind, ordinary stock market investments: in the case of private-equity-fund investments, for nearly a decade; and in the case of investment in hedge funds, since 2005. It also warned that private-equity takeovers—heavily using pension funds' invested assets—have been shrinking the stock markets for public stocks into which pension funds have traditionally been invested; that they pit older workers' interests against those of younger workers in the pension plans; and that the debt bubbles these funds are building up, are threatening a collapse of financial markets “as soon as credit conditions change.”

Credit conditions are now rapidly changing for the worse (see p. 62), and pension funds—with between 3% and 5% of their investments in hedge funds alone, depending on the report—are directly in the path of disaster. In the past two years, many public pension funds in the United States have added to their hedge-fund investments, their own direct purchase of the super-risky mortgage-backed securities (MBS) and their derivative collateralized debt obligations (CDOs) with which hedge funds and investment banks play. Analysts at real estate investment trusts and banks, warn *EIR* that the huge losses seen coming in these housing-bubble securities (losses in the hundreds of billions of dollars) are going to create a second-wave pension crisis in the United States.

The first wave was low returns and corporate cutbacks of pension contributions from the 1997-98 financial crises through 2005, worsened by Fed chairman Alan Greenspan's drastic lowering of interest rates. The second wave will be outright losses, stemming from pension funds' efforts to “make up” for the earlier crisis by plunging into hedge funds and private equity funds, looking for high-return “junk” to invest in. From junk, they have progressed to “toxic waste.”

Project Alpha

It started with the General Motors/UAW pension fund's “Project Alpha,” launched in 2003. That year, GM, behind in

its contributions to the pension fund, floated a large corporate bond issue in order to make an even larger, \$19 billion contribution—planning not to contribute again until 2011, and initiating a “secret” investment strategy managed by a team at Goldman Sachs, which other pension managers soon concluded was putting the GM investments into hedge funds. “Alpha” is the Wall Street term for above-average returns—exactly what the ITUC study, and an in-depth earlier study by MIT and the University of Chicago, concluded you don't get from private-equity funds, and now hedge funds.

By 2007, according to a June 18 report by Greenwich Associates, 25% of all the hyper-leveraged assets managed by large hedge funds (\$1 billion or more) internationally, belong to pension funds and endowments. In addition to that, pension funds provide some 20% of the investments in “hedge funds of funds”—operated by banks, and highly leveraged—which in turn provide another quarter of the investments into hedge funds. So the pension fund/endowment share of hedge funds' assets is really about 30%.

Some 40% of the *new* flow of assets into the hedge funds is currently coming from pensions. And in fact, the overall flow of capital into hedge funds has dropped dramatically at the same time—from \$40 billion each quarter over January-September 2006, to just \$12 billion in fourth quarter 2006, and \$20.7 billion in first quarter 2007. In other words, pension fund money coming in, is allowing “smart” money to get out of the hedge funds. Numerous reports, including a new one from Chicago-based Hedge Fund Research, Inc., have shown “high net-worth individuals” reducing their net hedge fund investments by half, between 2006 and 2007—investing instead into real property and stocks. They now account for only about 20% of the assets of hedge funds, which were supposedly made for them.

Looked at from the other standpoint, the proportion of pension fund investments which are in hedge funds and “hedge funds of funds” has risen to about 3%, according to Greenwich Associates. But among public employees' pension funds in the United States, the portion is higher, between 5% and 6%. The largest of all, the \$245 billion California Public Employees Retirement System (CalPERS), which now has 2% invested in hedge funds, on June 19 raised its hedge-fund investments to 4% and its targetted range to 8%. That's a lot

of pension money to lose.

Yet, the Colorado Public Employees Retirement Association (PERA), which has a pension liabilities deficit to make up, has, since 2004, realized higher returns each year, investing exclusively in conservative public stocks, than has CalPERS with its hedge funds, or GM with its “Project Alpha.” And large losses have already begun. The San Diego County Employees Retirement Association invested and lost \$153 million, 3% of its assets, in the large Amaranth Advisors hedge fund, which crashed in October 2006. The San Diego fund was one of seven pension funds hit with Amaranth losses, including those of the state employees of Pennsylvania, New Jersey, and Maryland; city employees’ pension funds of Philadelphia and Chicago; and the 3M Corp.

But despite such losses, some of the same public pensions are making or planning bigger plunges into hedge funds. The New Jersey State Employees’ plan, in a fit of desperation for “junk”-level returns to make up a large deficit, is investing \$20 billion into hedge funds. Richmond, Virginia’s employee pension fund, already 5% invested in hedge funds, is “studying” raising that to 7%. The Pennsylvania state employees’ fund increased its hedge-fund level to 4%, after losing \$33 million in the Amaranth collapse. New York City’s pension plans, which have never invested in hedge funds, are making plans to do so.

These decisions are being made as the failures of large hedge funds are suddenly proliferating due to the spread of the MBS/CDO contagion from the meltdown of the U.S. housing bubble. Just the past two months have seen the collapse of the two multi-billion-dollar Bear Stearns funds; the shutdown of the billion-dollar Caliber Capital Management fund in London; the shutdown of UBS bank’s largest hedge fund with \$130 million losses; and large losses by the big Goldman Sachs “fund of funds” called Global Alpha—to mention only the biggest cases.

The So-Called Toxic Waste

In the virtual panic (“can’t sell ’em”) which now has leaped from the U.S. MBS pit and seized the global markets for CDOs and even more exotic derivatives, the talk is all of securitized bets on categories of junk debt called investment grade, mezzanine, subprime, and equity—the last also known on Wall Street as “toxic waste.” These bonds have been bought because S&P, Moody’s, Fitch, and other ratings agencies rated them, apparently, falsely. A list of U.S. pension funds which have bought the last-to-be-paid “equity” tranches of CDOs includes, according to financial analyst John Mauldin on June 27: “The New Mexico Investment Council (\$222 million, and another authorized \$300 million, for 3% of its total fund); the General Retirement System of Detroit (\$38.8 million); the Teachers Retirement System of Texas (\$62.8 million); CalPERS...” (the amount, not noted by Mauldin, is \$541 million). Over a decade, pension funds and endowments have bought 7% of all the “toxic waste” investment banks and

hedge funds had on offer. Why? Because of promised, very high returns. Some of these subprime-rated tranches paid a huge 10% over the London Interbank Borrowing Rate (LIBOR). Some “equity” portions offered 20% above LIBOR.

Mauldin analyzed one large MBS issue of 2006, typical of those bought by the pension funds’ feeding-frenzy for high returns, and found that in May 2007, some 54% of the loans it was based on were more than 60 days delinquent, and 17% of them were already in foreclosure.

Bloomberg Markets magazine, in a late June article called “The Rating Charade,” traced back one such CDO security, issued in 2000 by Crédit Suisse, and combining primarily MBS into five basic “tranches” of debt. The big three ratings agencies named above rated 95% of the whole CDO, investment grade, triple-A or double-A. And what was the fate of those who bought the CDO tranches in 2000? The AAA and AA tranche buyers, or the insurance they bought, lost 25%; all the rest of the CDO was a complete loss. In total, \$120 million was lost, or 35%, on the entire CDO, which had been issued with a 95% AAA rating.

On June 29, 2007, Bloomberg News reported it had done a broad review of MBS issues of debt based on the U.S. mortgage market, and found that 65% of them needed to be downgraded by the ratings agencies. “Take the 300 bonds that are used in the ABX indexes, the benchmarks for the subprime mortgage debt market,” researcher Mark Pittman wrote. “190 fail to meet the credit support standard [the ratings agencies used until 2005], according to data released in May by trustees responsible for funneling interest payments to debt investors. Most of those, representing about \$200 billion, are rated below AAA. Some contain so many defaulted loans, that the credit support is outweighed by potential losses. Fifty of the 60 A-rated bonds fail the criteria, as do 22 of the 60 AA-rated bonds and three of the 60 AAA-rated bonds.”

As the credit crunch hitting the worldwide CDO markets intensifies, it will be impossible for many of these “investment assets” of the pension funds to be sold at any price. Hedge funds, as they get into trouble in this crisis, block their investors from withdrawing capital for up to 60-90 days, at which point it has usually been too late, as in the Amaranth, RefCo, and Bear Stearns cases.

This is why inside observers of the mortgage and MBS meltdown, watching it from within financial institutions in New York, London, Boston, etc., warn of a new and much larger pensions crisis. They understand that the waves of MBS and CDO losses, perhaps up to near \$1 trillion, will hit the hedge funds and investment-bank “hedge funds of funds” above all. But they see the hedge funds’ managing partners using the Summer and Fall months of the crisis to continue “working themselves out” from these losses, with the foolish assistance of the pension funds that are continuing to “work themselves in.” IPOs by private equity funds, and huge funds of pension money into hedge funds, are two aspects of this same process.